The Fundamental Deficiencies of the Agreement on Safeguards: A Reply to Professor Lee

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In a recent issue of this journal, Professor Yong-Shik Lee published a comment on my 2004 article, The Persistent Puzzles of Safeguards: Lessons from the Steel Dispute, which was published by the Journal of International Economic Law. I thank Professor Lee for his commentary, and also thank the Journal of World Trade for affording me this opportunity to reply to Professor Lee.

Professor Lee takes issue with a number of points in my original article, some minor and some more fundamental. In doing so, he misunderstands my position on some issues, and he fails to appreciate the economic critique of the legal standards in safeguards cases that I develop (and which, by the way, has also been put forward by prominent international economists). A point-by-point rebuttal to Mr Lee would embroil the reader in a tedious level of detail, however, and so I will concentrate in this reply on what I believe to be the core problems with Professor Lee’s commentary. On some of the more minor points raised by Professor Lee, I refer the reader to my forthcoming book, The WTO Agreement on Safeguards: A Legal and Economic Commentary, which will be published by Oxford University Press in 2006.

Section I lays out what I believe to be the most fundamental problems with the treaty text on safeguard measures, as interpreted to date by the Appellate Body. Section II then considers Professor Lee’s response to this analysis, and shows how it is misguided. Section III briefly addresses some subsidiary issues.

I. THE FUNDAMENTAL PROBLEMS

Both my original article and Professor Lee’s commentary touch on a broad range of legal questions in safeguards cases. But the central problems with the treaty text and its interpretation to date by the Appellate Body, as well as my key disagreements with Professor Lee, stem from two related issues. First, notwithstanding the language in Article 2.1 of the Agreement on Safeguards, it is simply incoherent to treat “increased imports” as a potential “cause” of injury to import-competing industries. Second, because “increased imports” cannot properly be understood as a causal variable, it becomes impossible to conduct an intelligible “non-attribution” analysis to separate the

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injury caused by "increased imports" from the injury caused by "other factors". As a result of these twin problems, national authorities face massive hurdles, perhaps insurmountable ones, in their efforts to demonstrate compliance with the treaty text. Not only has every safeguard measure that has been challenged in the dispute settlement process to date been found to violate World Trade Organization (WTO) law, but the treaty text and its interpretation by the Appellate Body may well make it impossible for any measure to withstand challenge in the future. Those who view safeguard measures as nothing more than wasteful protectionism may welcome this state of affairs, but for those who believe that safeguards have a constructive role to play in the trading system, the current situation is quite unsatisfactory. In this section, I elaborate these key points, and in the next section turn to Professor Lee's flawed response.

A. The fallacy of treating increased quantities of imports as causal

Like US law, the Agreement on Safeguards asks national authorities to answer a question, which, to an economist, makes no sense. Article 2.1 of the Agreement states that "[a] Member may apply a safeguards measure to a product only if... such product is being imported into its territories in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products". Thus, the treaty text (like the applicable US statute, Section 201 of the Trade Act of 1974, from which this text may in part have been drawn) asks national authorities to determine whether increased quantities of imports have caused serious injury or threat thereof to domestic competitors. For this question to be well posed, it must be possible to conceptualize "increased quantities of imports" as a causal variable that is potentially responsible for injury.

Elementary price theory teaches, however, that increased quantities of imports do not "cause" conditions of injury (decreased price and production, reduced employment, and the like) at all, any more than such conditions of injury "cause" increased imports. Rather, both increased imports and conditions of injury result from various exogenous economic shocks that may have their origins in the importing nation or abroad. For example, a shock to domestic firms that raises their production cost will lead them to attempt to adjust their prices upward to cover their higher costs. As they do so, they will lose sales to imports whose producers have not suffered the same cost shock. Domestic production and employment ("injury") will thus occur concurrently with increasing imports, both having been "caused" by the domestic cost shock. As another example, borrowing from the facts that led to the safeguard measure at issue in the old GATT Hatter's Fur case,2 suppose that domestic and imported goods are imperfectly substitutable in the eyes of consumers (in Hatter's Fur, imported hats were

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of one style and domestic hats were of another). Imagine that a change in consumer tastes (such as the change of fashion at issue in *Hatter's Fur*) leads consumers in the importing nation to prefer the imported product to a greater degree, and the domestic product to a lesser degree. The result will be an increase in imports, accompanied by a decrease in domestic production, prices and so on. These developments are again concurrent, neither "causing" the other, but both resulting from the change in tastes. Other types of shocks can be posited, but in all instances the change in the quantity of imports, and the change in indicators of domestic injury, are together the result of some other shock. For this reason, it is simply mistaken to say that increased quantities of imports cause conditions of injury.

Professor Lee acknowledges that this concern has "economic plausibility". If its "plausibility" requires any bolstering, note that the same basic point has been echoed widely by prominent economists, including Gene Grossman, Henrik Horn, Douglas Irwin, and Robert Pindyck.

Elementary economics thus reveals that the treaty text embodies a fundamental deficiency—the central question that it asks national authorities to answer presupposes a causal relationship that does not exist. If national authorities are to answer the question nevertheless, they must do one of three things, none of which is terribly satisfactory. The first option is to ignore the problem, and to proceed to make the most fundamental of statistical errors—to pretend that correlation and causation are the same. This "correlation" approach to causal analysis has indeed been the usual approach of national authorities in the United States, and has seemingly been endorsed in substantial measure by the Appellate Body (see, for instance, its endorsement on the panel's reasoning in *Argentina—Footwear*).

Causation will be said to exist, even though it does not, when increasing quantities of imports arise contemporaneously with indicators of injury. Any economic shock that produces both increased imports and injury then becomes a potential basis for a safeguard measure, regardless of the nature of the shock.

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3 Lee comment, p. 397.


8 WT/DS121/AB/R. (14 December 1999), 144 (hereafter *Argentina—Footwear AB*).
The second option is to interpret the treaty text as asking a different question. One could ask, for example, whether the shock that has produced increased imports and injury has its origin in the importing nation or abroad. This is, in essence, the approach advocated by a number of the economic commentators cited above, who suggest that injury should be deemed to be caused by “increased imports” only if it is due to a shock that shifts the import supply curve. A shock resulting in reduced costs for foreign producers would be an example, as would a demand shock abroad that caused prices to fall and led foreign producers to seek out more export opportunities by lowering their export prices. If the shock originates in the importing country, by contrast, as in my examples above involving a shock to domestic costs or to domestic consumer tastes, no injury would be attributed to “imports” under this approach to causal analysis. I refer to this type of analysis as the “import supply curve approach” in my prior writings.

Another reinterpretation of the question asked by the treaty text, put forward by Robert Pindyck and Julio Rotemberg in the context of a US investigation of the copper industry, would attribute injury to “imports” to the degree that a counterfactual quantitative restriction on imports, limiting imports to their levels during some baseline period, would have averted injury. I refer to this in my prior writings as the “hypothetical quota” approach to causation analysis. This alternative would permit a finding of causation in my earlier examples (subject to the caveats below about the “non-attribution” requirement), since a restriction on imports would avert some portion of the injury attributable to either a domestic cost shock or to a change in domestic consumer tastes.

The third option relates to the decision by the Appellate Body to resurrect the “unforeseen developments” requirement of GATT Article XIX. Unlike Article 2.1 of the Agreement on Safeguards, quoted above, Article XIX(1) permits a safeguard measure only “if, as a result of unforeseen developments and the result of the obligations incurred by a contracting party under this Agreement, any product is being imported ... in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers”. Thus, Article XIX adds the requirement of a linkage between the import surge and both “unforeseen developments” and “obligations incurred” under GATT. Despite this language in Article XIX, GATT practice over time came to ignore these requirements as I, and others, have documented elsewhere. The drafters of the Agreement on Safeguards likewise omitted any reference to such matters, and one might have supposed that these requirements were dead letters. But the Appellate Body held in its earliest safeguard decisions (Korea—Dairy and Argentina—Footwear) that Article XIX and the Agreement on Safeguards must be read cumulatively, thus restoring the formal requirement for members to demonstrate “unforeseen developments” before utilizing a safeguard measure. (The Appellate Body apparently considers it sufficient to establish a linkage to “obligations incurred” if the importing Member can show that it has undertaken some

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9 See Pindyck and Rotemberg, as note 7 above, for details.
GATT obligations with respect to the products in question, such as a bound tariff.\(^{10}\) Whatever the legal merits of this holding (see below), it has the potential to reintroduce a coherent causal variable into the analysis—an "unforeseen development(s)". One might thus ask the question not whether increased quantities of imports have caused injury, but whether an unforeseen development(s) has caused injury through its impact on the competitive balance between domestic and foreign producers.

Each of these options has its problems. The first option, reliance on correlation as a substitute for causation, simply papers over the fundamental deficiency in the treaty text, and potentially permits safeguard measures (subject to "non-attribution") whenever a correlation exists between import quantities and indicia of injury, regardless of the true cause of the problem. It is at least questionable whether the drafters of GATT, or of the Agreement on Safeguards, had such a system in mind. Reliance on mere correlation also clashes with the Appellate Body’s repeated insistence that national authorities offer a "reasoned and adequate" explanation for their decisions—the conflation of correlation and causation is never reasoned and adequate.

Both variants of the second option reinterpret the treaty text in a way that is not compelled by its language, and has no obvious grounding in public policy either. Although the import supply curve approach does bring logical coherence to the causation inquiry as its economic proponents argue, it is by no means clear that the drafters of the GATT and the Agreement on Safeguards intended to limit safeguards to addressing only injury caused by import supply shifts. This approach would rule out safeguard measures on the facts of Hatter’s Fur, for example, even though the GATT working party examining the case seemed to accept in principle the US justification for its measures.

The hypothetical quota approach is perhaps more easily squared with the treaty text ("increased imports" are deemed to cause injury to the extent that a quota preventing the increase would have avoided injury), but this approach (like reliance on mere correlation) would attribute injury to increased imports anytime that imports have increased above the proposed baseline, irrespective of the underlying cause. The obvious worry is that this approach, like reliance on mere correlations, may open the door too widely to safeguard measures—as long as imported and domestic goods compete with each other, a hypothetical quota restricting imports to some baseline level will always benefit the producers of domestic goods. This interpretation of the treaty text thus has the potential to render the requirement of a causal connection between increased imports and injury essentially a nullity, and the right to use a safeguard measure would then turn entirely on whether the other requirements of Article XIX and the Agreement on Safeguards had been satisfied.\(^{11}\) It is questionable

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\(^{10}\) See Argentina—Footwear AB 91.

\(^{11}\) The hypothetical quota approach is perhaps somewhat less troubling under US law, where it was applied by Pindyck and Rotemberg, because US law adds the requirement that imports be an important cause of injury and no less important than any other (the substantial cause test). There is no comparable requirement in WTO law, and without it, the hypothetical quota approach will lead to a finding that increased imports are causally responsible for some quantum of injury in every case.
whether the drafters of the treaty text would have wished to make the causation requirement so easy to satisfy.

The third option, emphasizing the injury attributable to an “unforeseen development(s)”, has the twin virtues of being economically coherent and grounded in the treaty text (albeit in Article XIX only), but the conceptual and practical challenges associated with it are daunting. The task of tracing through the effect of an “unforeseen development” on import volumes in national markets poses potentially enormous empirical challenges. Even if such challenges could be overcome, there would remain the thorny conceptual question of how to determine what counts as an “unforeseen development” in the first instance. Can a domestic cost shock count as an unforeseen development, for example? A change in domestic consumer tastes? A shift in exchange rates? How can we tell if these and other events are “foreseen” or not? More generally, are there any limits on the “unforeseen developments” that can serve as a basis for safeguards protection?

In sum, the causal inquiry posed by the treaty text is conceptually flawed and the proper way for WTO Members to proceed in the face of this problem is entirely unclear. Members of the WTO are desperately in need of further guidance if they are to be able to employ safeguard measures with any degree of confidence about their legality. Such guidance might come from a renegotiation of the Agreement on Safeguards, but no prospect of renegotiation is in sight. Alternatively, guidance might come from a creative, policy-based interpretation of the Agreement by the Appellate Body. To date, however, the Appellate Body has shown no inclination to proceed down that path, perhaps fearing that to do so would overstep its authority. The result has been a series of wooden, largely useless and often logically incoherent decisions that simply underscore the deficiencies of the treaty text without clarifying them in the least. I will elaborate this point in section II.

B. THE FALLACIES OF “NON-ATTRIBUTION” ANALYSIS

The problem gets worse. Not only does the Agreement on Safeguards require a “causal link between increased imports of the product concerned and serious injury or threat thereof”—a link which does not exist for the reasons developed above—but Article 4.2(b) of the Agreement on Safeguards further provides that “[w]hen factors other than increased imports are causing injury to the domestic industry at the same time, such injury shall not be attributed to increased imports”. This text is the basis for the so-called “non-attribution” requirement in safeguards investigations. The non-attribution requirement, as interpreted by the Appellate Body, requires national authorities to take the analytical step of identifying the other factors causing injury, and then assigning to those other factors the injury attributable to them, so as to ensure that such injury is not erroneously attributed to increased imports. As I document in detail in my prior writings, the non-attribution requirement has regularly been a basis for panel and Appellate Body decisions finding safeguard measures to be illegal. What the
decisions to date fail to appreciate, however, is that the “non-attribution” exercise required by Appellate Body precedent is often logically impossible to perform!

Some examples drawn from the WTO cases will make the point. In US—Lamb, respondents in the investigation before national authorities argued that any injury suffered by the US industry was caused by factors other than increased imports. Among the other factors noted by respondents was the cessation of a domestic subsidy programme in the United States—certain payments previously made under the National Wool Act of 1954. The Appellate Body held that the US International Trade Commission’s (USITC) non-attribution analysis was deficient in regard to its treatment of this “other factor” as well as several others: “it is impossible to determine whether the USITC properly separated the injurious effects of these other factors from the injurious effects of imports”.

The difficulty lies in the fact that such an “other factor” is precisely the sort of economic shock that causes an increase in imports! If subsidies under the National Wool Act are discontinued, costs rise for domestic producers. When firms experience higher costs, they will seek to raise prices to cover their higher costs. As domestic firms do so, imports (which have not experienced the same cost shock) become relatively cheaper and imports increase. Domestic firms sell less and lose sales and market share. In short, the cessation of subsidy payments causes an increase in imports, and concurrently causes conditions in the domestic industry that reflect “injury”. Given that economic reality, how can national authorities possibly “separate” the effects of the cessation of subsidies from the effects of “increased imports?” This question has no coherent answer, and the Appellate Body’s insistence that national authorities answer it nonetheless, in “reasoned and adequate” fashion, poses a seemingly insurmountable obstacle to a legally adequate causal analysis.

This logical problem has repeated itself in numerous other decisions. To offer just one more example, as I document in the article on which Professor Lee comments, United States—Steel involved a question in the hot-rolled bar “industry” as to whether an increase in the cost of goods sold for domestic firms was an “other factor” that was responsible for injury, and whether the USITC had erroneously “attributed” injury caused by that factor to increased imports. It was again held that the non-attribution analysis on this point was inadequate. Yet, it is obvious that an increase in the cost of goods sold will have precisely the same effect as a cessation of subsidy payments. Domestic costs and prices will rise, imports will increase, and indicators of “injury” will emerge. It is simply impossible to separate the effects of an increase in cost of goods sold from the effects of an increase in imports.

12 This argument is, of course, correct, since increased imports never cause injury as stated above.
13 United States—Safeguard Measures on Imports of Fresh, chilled or Frozen Lamb from New Zealand and Australia (US—Lamb), WT/DS177/178/AB/R (16 May 2001), 185–186.
14 Professor Lee suggests at one point that my remarks about this issue in the steel case embody a “logical contradiction” given the US ITC finding that import competition had suppressed prices. He states: “If the domestic price did not rise despite the increased costs, then there was no price advantage for imports. So, how could import increases possibly have been caused by the increase in cost of goods sold?” Lee comment, p. 402. Far
One might again ask what is to be done in the face of this problem. The options are much the same as those discussed in the prior section. First, one can ignore the issue, and perform the same silly correlation analysis when examining the impact of other factors as is done in examining the impact of imports. If indicators of injury appear more closely correlated with trends in import volumes than with time series data representing the “other factor”, one might opine that increased imports are causally responsible for injury and that the “other factor” is not. This approach is doubly ludicrous, of course, when the “other factor” is causally responsible for increased import volumes.

The second option is again to reinterpret the treaty text as asking an intelligible question. The economic commentators who embrace the import supply curve approach to causal analysis would define any economic shock that shifts the import supply curve as a shock associated with “increased imports”, and likewise define any shock affecting domestic supply or demand conditions as an “other factor”. It then becomes possible as a logical matter to separate the effects of “increased imports” from those of “other factors”. But again, there is little or no textual basis for proceeding in this fashion, and it is hardly clear that it offers the right approach as a policy matter.

The hypothetical quota approach to causal analysis can also be adapted to the “non-attribution” exercise, albeit clumsily for reasons that will become apparent. Just as one can ask how much better off the domestic industry would have been had imports been restricted to some baseline level, one can also ask how much better off the industry would have been had some “other factor” been held constant over time. In the above example from US—Lamb, one might thus ask how much better off the US industry would have been had subsidies under the National Wool Act remained constant over time instead of being terminated. But this sort of exercise can quickly become absurd. Suppose, for example, that the only shock to the US market was the cessation of Wool Act payments. Then, all of the injury would have been averted had the Wool Act payments remained in place. But some of the injury would also have been averted by a quota that restricted imports to their baseline levels at the time the Wool Act payments ceased. Thus, an adaptation of the Pindyck–Rotemberg approach would lead to the odd result that all of the injury was attributable to the “other factor”, yet part of it was also attributable to imports! This seeming absurdity results, of course, from the fact that imports are not a causal variable at all—the only

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from being a logical contradiction, my comment is precisely in line with elementary price theory. Consider a market for steel in which domestic producers have an upward sloping supply curve, and the supply of imports is highly elastic—a highly plausible scenario given the depth of the global steel market. Domestic producers then experience a cost shock that results in higher cost of goods sold. The domestic supply curve shifts upward, resulting in reduced domestic sales and increased imports. Prices change little if at all because import supply is highly elastic. Once again, the only causal variable in this scenario is the domestic cost shock, which yields an increase in imports concurrent with a decrease in domestic production. If Professor Lee encounters a logical problem here, it is his own failure to appreciate the logic of elementary price theory.

15 Pindyck and Rotemberg, cited in note 7 above, provide a more complete explanation of this point.
coherent causal variable in this scenario is the change in subsidies policy under the Wool Act.

Finally, one could trace out the logic of a greater focus on “unforeseen developments” to adapt it to a non-attribution exercise. To the degree that increased imports and injury result from a qualifying “unforeseen development”, one might say that injury is not due to any “other factor”. Conversely, if the cause of increased imports and injury is not among the pertinent “unforeseen developments”, one might conclude that injury is due to some “other factor”. This approach is coherent as a purely logical matter, but shifts the game to the task of distinguishing “unforeseen developments” from “other factors”. Can a shock such as the cessation of payments under the National Wool Act count as an “unforeseen development”, or is it an “other factor”? Should the panel and Appellate Body in US—Lamb have inquired whether the cessation of Wool Act payments was “unforeseen”? What about an increase in the cost of goods sold to the domestic steel industry? Or a change in hat fashions as in Hatter’s Fur? Is any economic shock that causes injury along with a contemporaneous increase in imports a proper basis for safeguard measures as long as it is “unforeseen”, or should there be some limitations?

As before, the system is desperately in need of guidance on how to differentiate “other factors” from the effects of “increased imports” in order to satisfy the “non-attribution” requirement. The treaty text is woefully deficient, and Appellate Body decisions to date have confounded rather than clarified the problems. As things stand, the Appellate Body steadfastly insists on a “reasoned and adequate” non-attribution analysis, notwithstanding the logical impossibility of performing it in many settings. One can imagine possible routes to something more coherent, but nothing in the treaty text or the decisions to date provide the slightest hint as to how to proceed.

II. PROFESSOR LEE’S RESPONSE AND ITS DEFICIENCIES

Professor Lee’s commentary reveals that he does not appreciate the implications of these issues, which are core logical problems with the structure of the treaty text as interpreted by the Appellate Body to date. I will proceed by laying out what I understand to be his objections to my analysis, and then argue that each of them is misguided.

A. PROFESSOR LEE’S DISTINCTION BETWEEN “ULTIMATE” AND “PROXIMATE” CAUSES

Professor Lee begins by acknowledging that my critique of the causation standard in the treaty text “may be economically plausible”, but goes on to state that:

I believe it is a matter of which perspective one takes and of where one stops in the presence of multiple layers of causes with one leading to another. From the perspective of the affected domestic industry, an increase in imports can still be considered to be a cause for injury no matter what factor may have, in turn, caused the increase in imports. For instance, suppose that customer
preference may have changed in favour of imports, leading to a rapid increase in imports ...
From the perspective of domestic producers, what takes away their revenue and, therefore, what
causes their injury would be imports no matter what—customer preference or otherwise—has
resulted in the increase in imports. Consequently, the position of domestic ... producers would
improve by suppressing imports.16

Later, he adds:

Suppressing imports would relieve domestic producers temporarily (which safeguard measures
are supposed to do), although the increase in imports may not be an “ultimate” cause for the
injury but may only be a “proximate” cause. The Agreement on Safeguards does not make a
distinction between “ultimate” and “proximate” causes.17

In these passages, Professor Lee seems to be saying three different things. First,
regardless of economic learning on the subject, domestic industries perceive increased
imports as the cause of their problems. Second, even though increased imports are
caused by various economic shocks, they are nevertheless an intermediate or
“proximate” cause of injury. Third, and most importantly, he seems to be saying
that irrespective of the underlying cause of increased imports, it is appropriate to view
them as a proximate cause of injury justifying a safeguard measure when “the position
of domestic producers would improve by suppressing imports”. I will take each point in
turn.

The first point is quite immaterial. For many centuries, even the most astute
scientists perceived that the Sun orbited the Earth. That perception did not make it so.
Neither do the mistaken perceptions of modern day actors about causation in markets.
Those erroneous perceptions can perhaps explain why the treaty text was drafted in
such a deficient way, but does not help with its application.

The second point is closely related to the third, and is simply mistaken. It is wrong
in general to characterize imports as an intermediate or “proximate” cause of injury, as
if there exists a temporal sequence leading from an “ultimate” cause, to the
“proximate” cause of increased imports, and then to conditions of injury. To make
the point, consider the earlier example of a domestic cost shock (like the cessation of
subsidy payments in US—Lamb). If one were to attempt to construct a causal sequence,
one would see that the cost shock leads to actual or attempted price increases by
domestic firms, which in turn lead customers to turn to imports and at the same time to
turn away from domestic purchases. In no sense are increased imports the “proximate
cause” of anything in some temporal sequence. As another illustration, consider
Professor Lee’s own example of changing consumer tastes that favour imports. Here,
one would say that the consumer’s decision to buy an imported good instead of a
domestic good was the sole cause of everything subsequent, with the rise in imports and
the decline in domestic sales again occurring simultaneously. Attempts to characterize
increased imports as an intermediate or “proximate” cause do not solve the problem

16 Lee comment, p. 397.
17 Ibid., p. 398.
with the treaty text. Nor are such attempts helpful in the slightest at resolving the incoherence in “non-attribution analysis”, as I explain below.

This brings me to Professor Lee’s third and most important point. When he suggests that the ultimate cause of the increase in imports is irrelevant as long as “the position of domestic ... producers would improve by suppressing imports”, he embraces without acknowledging it a particular interpretation of GATT Article XIX and the Agreement on Safeguards. He says, in effect, that whenever the suppression of imports would benefit the domestic industry, increased imports can properly be deemed a cause of injury whatever the “ultimate cause” of market developments (with the proviso, to be sure, that the other prerequisites for safeguard measures under WTO law must still be satisfied before a safeguard measure can be imposed). But it is always the case that the suppression of imports will benefit a domestic industry that competes with them. The only circumstance in which import suppression would not benefit a domestic industry would be one in which there was no substitutability between imported and domestic goods. Yet, in such a case, the domestic products would not be “like or directly competitive” with the imports, and the use of a safeguard measure would be ruled out for that reason alone.

Professor Lee’s interpretation of the causation requirement is in fact nothing more than a restatement of what I described above and in my prior writings as the hypothetical quota approach to causation analysis, whereby one deems increased imports to have caused injury to the degree that a hypothetical quota, restraining imports to some baseline level, would have averted injury. But recall the objections to this approach. First, it opens the door to safeguard measures irrespective of the nature of the shock that has caused market disruption. Would the drafters of the treaty text have intended such a broad scope for safeguard measures? An affirmative answer is difficult to defend since, as noted, such a reading renders the requirement of a causal link between increased imports and injury a practical nullity.

Second, this approach again leads to absurdity in “non-attribution” analysis. Recall the earlier example of a domestic cost shock that causes an increase in imports. Professor Lee would apparently say that increased imports caused injury in that example, because domestic producers would benefit from import suppression. Yet, all of the injury is attributable to the domestic cost shock in my hypothetical, and if the domestic cost shock is an “other factor”, such injury “shall not be attributed to increased imports” under Article 4.2(b) of the Agreement on Safeguards. We are again in a quandary as to how to proceed. The same problem would arise in Professor Lee’s own example if changes in “customer preference” were considered an “other factor”.

It should now be clear that Professor Lee’s distinction between “ultimate” and “proximate” causes does nothing to solve the core problems set out above. Not only does it rest on an economic fallacy about the causal chain, but as a practical matter, it amounts to the “hypothetical quota” approach to causation analysis (although Professor Lee does not acknowledge or perhaps realize this fact). Professor Lee offers nothing to respond to the objections to that approach that have been identified here and elsewhere.
B. **Professor Lee's Defence of the "Three-Prong" Causation Requirement**

Notwithstanding these difficulties, Professor Lee insists that WTO jurisprudence has provided "useful guidance in the determination of causation". He points to the "three-pronged test" developed by the panel in *Argentina—Footwear*, which was approved by the Appellate Body:

The first prong is whether an upward trend in imports coincides with downward trends in the injury factors, and if not, whether a reasoned explanation is provided as to why the data nevertheless show causation. The second is whether the condition of competition in the domestic market between imported and domestic products based on objective evidence demonstrates a causal link between the imports and the injury. The third prong is whether other relevant factors have been analysed and whether it is established that the injury caused by factors other than the imports, has not been attributed to these other factors.¹⁸

The claim that this three-pronged test affords "useful guidance" is deeply mistaken in my view, and again suggests that Professor Lee has failed to appreciate the key points made in the article on which he comments.

The first prong, a search for "coincidence" between import trends and indicia of injury, simply searches for temporal correlations. As noted above, correlation is not causation. And it is not even indicative of causation where, as here, theory tells us that increased imports do not cause anything. A search for correlation in this context is no more respectable than the proverbial search for a relationship between hemlines and the stock market.

As noted earlier, if the treaty text is reinterpreted to ask a different question, such as whether a hypothetical quota would have benefited the domestic industry, whether a shift in the import supply curve may have caused its distress, or whether some "unforeseen development" may have led to adverse market conditions, one can answer the question coherently, at least in principle. But it would still be folly to rely on correlations between import volumes and indicators of injury to establish the relevant causal relationship. As noted, a hypothetical quota will always benefit a competing domestic industry as a purely theoretical matter. Nothing about the strength of the correlation between import volumes and indicators of injury can affect this conclusion. If the focus is instead on injury due to shifts of the import supply curve, correlation between import increases and indicators of injury can easily arise without any import supply shift, as noted in the discussion of domestic cost shocks and changes in domestic consumer preferences. And if the focus is on the effects of some "unforeseen development", an emphasis on import volumes and injury indicators tells us absolutely nothing about the magnitude of the effects attributable to the unforeseen shock in question.

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¹⁸ Lee comment, p. 399.
In short, the first “prong” of the test in Argentina—Footwear can play no useful role in any bona fide search for underlying causal relationships. To this point, Professor Lee responds:

[Sykes] is correct in pointing out that correlation is not causation, but not so when he overlooks the second prong, which augments the first. The three-prong causation test augments the correlation approach with the examination of market competition between domestic products and imports so that a mere correlation will not be considered to be a cause. An economic measure, such as the cross-elasticity of demand, can be used to determine the state of market competition between domestic products and imports. This three-pronged test provides reasonable baselines to determine the existence of causation . . .

Professor Lee thus suggests that whatever the weaknesses of a reliance on correlation to establish causation, the other two prongs of the Argentina—Footwear test, especially the second, should suffice to avoid erroneous causation findings.

Professor Lee is simply wrong. At the risk of being repetitive, he is once again oblivious to the basic point that increased imports do not cause anything. The Appellate Body could add another 1,000 prongs to the inquiry and it would make no difference.

If the causation requirement in the treaty text is reinterpreted in accordance with the hypothetical quota approach to causal analysis, as Professor Lee would seemingly favour (see the discussion of the last section), then “causation” exists trivially in every case because any industry will benefit from restrictions on competing imports. Various “prongs” in the analysis can only mask this reality.

The second prong of the Argentina—Footwear test, in particular, which has come to be known as “conditions of competition” analysis, simply does not assist in assessing “causation”. As I document in detail elsewhere, conditions of competition analysis in practice embodies primarily two things—a search for evidence that imports are “underselling” (i.e., underpricing) domestic goods, and an examination of the correlation between the prices of imported and domestic goods. Professor Lee suggests in the quoted passage that an additional factor, the cross-elasticity of demand between imported and domestic goods, might also be examined.

“Underselling” does not occur in markets populated by well-informed buyers if goods are perfect substitutes, except as a transitory disequilibrium phenomenon of little significance. When one product systematically undersells another, the primary reason is that the goods in question are viewed as imperfect substitutes by consumers. A product will undersell another if consumers view it as lower in quality or desirability for some reason. Systematic evidence of underselling by imported goods, therefore, generally establishes nothing more and nothing less than the fact that consumers view imports as lower in quality or desirability.

Similarly, the prices of imports will tend to be more highly correlated with the prices of domestic goods, the more highly substitutable the goods are by consumers. In

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the case of perfect substitutes, the correlation between the prices of imported and domestic goods at the same time and location will be nearly perfect. As goods become less substitutable, it is possible for their prices to diverge more widely and more often, and the correlation will tend to weaken. Thus, like the evidence of underselling, the price analysis that forms part of the usual "conditions of competition" analysis simply tells us something about the degree to which imported goods and domestic goods are close substitutes.

Finally, the cross-elasticity of demand is itself nothing more than a conventional economic measure of the degree to which two goods are substitutes in the marketplace. A high, positive cross-elasticity implies that goods are closer to perfect substitutes, while a zero cross-elasticity implies that goods do not compete with each other at all (a negative cross-elasticity implies that goods are complements).

Thus, "conditions of competition" analysis in all of its manifestations simply yields information about the degree of substitutability between domestic and imported goods. Evidence of systematic underselling indicates further that imports are perceived to be of lower quality or desirability. But on what theory is "causation" in any meaningful sense present simply because imports and domestic goods are closer substitutes, or because imports are less desirable? Professor Lee never explains why these facts are relevant or useful.

To be sure, the degree of substitutability between domestic and imported goods can affect the extent to which economic shocks are transmitted from the market for imported goods to the market for domestic goods, and vice versa. For example, a domestic cost shock will tend to increase the quantity of imports to a greater degree, other things being equal, when imported goods are closer substitutes for domestic goods. Likewise, a shock that shifts the import supply curve will have a greater impact on domestic firms, other things being equal, when domestic and imported goods are closer substitutes. A quantitative restriction on imports will also produce greater benefits for domestic firms when imported and domestic goods are closer substitutes.

But the mere fact that imported and domestic goods are closer or weaker substitutes, or that imported goods are of lower or higher quality, tells us absolutely nothing about the underlying source of "injury" in a domestic industry. And it most certainly does not change the fact that "increased imports" are not a causal variable. When national authorities based findings of causation on the first prong of the *Argentina—Footwear* test—"coincidence" between import volumes and conditions of injury—they conflated correlation and causation as noted. A "conditions of competition" finding to the effect that imports and domestic goods are closer or weaker substitutes does nothing to correct that error, or to identify cases of genuine "causation", contrary to what Professor Lee asserts.

The third prong of the *Argentina—Footwear* test is nothing more than familiar non-attribution analysis. For the reasons given above, the non-attribution requirement as interpreted by the Appellate Body is hopelessly confused. Because increased imports are not a causal variable at all, it is impossible to separate their causal effects from "other
factors”, doubly so when the putative “other factor” is in fact a cause of increased imports, a problem that has arisen in a number of cases brought to the WTO dispute resolution system. Professor Lee’s suggestion that this third “prong” lights the way to sensible causation analysis is thus also erroneous.

III. OTHER ISSUES

As promised in the introduction, I will spare the reader a point-by-point rebuttal to everything that Professor Lee raises. But three other matters raised in his comment are important enough to warrant a brief response here.

A. THE RESURRECTION OF THE “UNFORESEEN DEVELOPMENTS” REQUIREMENT

As noted, the Appellate Body ruled in Argentina—Footwear and Korea—Dairy that GATT Article XIX and the Agreement on Safeguards must read cumulatively, and that the first clause of Article XIX, requiring a showing of “unforeseen developments”, remains applicable. It so held, despite the fact that GATT signatories had come to ignore this requirement during the last few decades of GATT, and despite the fact that the Agreement on Safeguards does not mention it.

Professor Lee suggests that I endorse this ruling as a legal matter. He misunderstands my position, apparently because of a passing reference in my earlier article to a potential “virtue” of the unforeseen developments requirement that he misinterpreted when taking it out of context.

In fact, in the article on which Professor Lee comments and in my various other writings on the subject, I express considerable scepticism about the soundness of the Appellate Body ruling on “unforeseen developments”. Because GATT practice converged on ignoring this text in Article XIX, at least as a formal prerequisite to safeguard measures, and because no reference to “unforeseen developments” can be found in the Agreement on Safeguards, I concur with Professor Lee (and with the panel decisions that the Appellate Body overruled) that the drafters of the Agreement on Safeguards probably did not intend to make a showing of “unforeseen developments” a precondition for safeguard measures.

Nevertheless, I noted that a possible “virtue” of the Appellate Body decision was that it offers a potential solution to the problems of causation analysis. As explained above, although it is not possible to view “increased imports” as a proper causal variable, it is logically coherent to ask whether some economic shock, in the nature of an “unforeseen development”, has produced both increased imports and conditions of injury (although the empirical challenges in making such a showing may be large). This approach to establishing a “causal link” is perhaps what the drafters of GATT had in mind in 1947, and is reflected in the discussion of the GATT working party in the 1951 Hatter’s Fur report (where the United States claimed that an unforeseen change in domestic consumer tastes had caused a dramatic shift from domestic to imported goods).
My intent was thus to suggest a possible way out of the causation conundrum, although not necessarily the best way, which builds on the Appellate Body rulings. More details on this potential approach to causation analysis may be found above, and in my other writings. But it was not my intention to endorse, from a legal perspective, a resurrected “unforeseen developments” requirement.

B. INCREASED IMPORTS AND THE BASELINE ISSUE

Both GATT Article XIX and the Agreement on Safeguards clearly require “increased quantities” of imports as a precondition for the use of safeguard measures. In my prior writings, I have focused considerable attention on the question of how to determine whether increased quantities are present—that is, how to select the proper baseline against which to assess whether an “increase” has occurred.

Import levels at the time of the initial GATT concessions provided a natural baseline in the early days of GATT. That baseline is to be found in the discussions of the Hatter’s Fur working party, for example, in 1951. But with the passage of time, and with additional negotiating rounds, the proper baseline became increasingly unclear. National authorities wrestled with the issue regularly. As I document elsewhere, the members of the USITC had divergent views on the issue. Some Commissioners searched for a period of time that they believe reflected long-term trends in the industry under investigation, which could produce a baseline extending back many years. Others looked back to the date of the most recent tariff concession on the product in question. Still others favoured an arbitrary rule of thumb. The latter approach eventually came to prevail for the most part, and the USITC generally came to rely on five years of data to assess the question of increased imports.

The question of the proper baseline came up in the first safeguard cases to proceed to WTO dispute settlement. In Argentina—Footwear, the Appellate Body seized on the phrase “such increased quantities” in the treaty text to hold that “not just any increased quantities of imports will suffice … the increase in imports must have been recent enough, sudden enough, sharp enough, and significant enough, both qualitatively and quantitatively, to cause or threaten to cause ‘serious injury’. The result of this standard has been a heavy emphasis in WTO dispute resolution on the most recent years or part years of import data.

I am critical of the standard set out by the Appellate Body for two reasons. First, as developed at length above, increased imports do not cause anything. The suggestion that the increase must be “recent enough, sudden enough, sharp enough and significant enough … to cause or threaten to cause serious injury” is thus gibberish on its face.

Second, if one considers the role of safeguard measures from a policy standpoint, it is hardly clear that the drafters of the treaty text would wish such a heavy emphasis on industrial conditions during the most recent months or years. The preamble to the

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20 *Argentina—Footwear* AB 130.
Agreement on Safeguards, for example, refers to the problem of "structural adjustment". The problem of structural adjustment can arise most severely in industries subject to long-term competitive decline. If one believes that safeguard measures have a useful role to play in facilitating structural adjustment—a debatable assumption on which I will not dwell here—then it would seem that safeguard measures should be available in industries suffering the greatest need for structural adjustment. Those industries may or may not have experienced a "recent", "sharp" import surge. Rather, they may have experienced a more gradual and long-term loss of market share to imports.

I thus worry that the Appellate Body may have misinterpreted the phrase "such increased quantities". That phrase need not be read as requiring a sharp, recent increase in imports, but simply a substantial enough shift in competitive position over a period of perhaps several years as to create the need for structural adjustment.

Professor Lee misunderstands these criticisms. He writes as though my objection is to the "qualitative" nature of the Appellate Body's standard, and as if I am insisting that they provide "quantitative" guidance. He defends the utility of qualitative guidance, and suggests that quantitative benchmarks are unrealistic and would intrude on the proper standard of review.21

I have no great quarrel with what Professor Lee says about "qualitative" guidance in the abstract, but it is simply unresponsive to my critique of the "increased quantities" standard set out by the Appellate Body. The problem lies not in the qualitative nature of the standard, but in its slavish insistence on causal linkages that do not exist, as well as its questionable emphasis on the presence of a recent and dramatic import surge. The Appellate Body derives implications from the word "such" and its context that are hardly compelled by the text, and that are not grounded in any apparent considerations of policy.

IV. CONCLUSION

I once again thank Professor Lee for his comment on my earlier article, and thank the Journal of World Trade for allowing me to reply.

The heart of my disagreement with Professor Lee, though by no means all of it, relates to a critical flaw in the causation standard of the treaty text that a number of prominent economists have also identified: increased imports do not cause injury. Rather, domestic input price shocks can cause both increased imports and injury. Domestic regulatory and tax policy changes can cause both increased imports and injury. Changing consumer tastes can cause both increased imports and injury. Macroeconomic shocks at home and abroad can cause both increased imports and injury (recall that an increase in import market share is enough to meet the increased

21 Lee comment, pp. 391–392.
imports requirement\(^{22}\)). Exchange rate movements can cause both increased imports and injury. This list is hardly exhaustive.

The fundamental question about safeguards policy is this—which shocks are an appropriate predicate for a safeguard measure? The presence in both GATT Article XIX and in the Agreement on Safeguards of a causation requirement suggests that the drafters had some sort of limitations in mind, but the phrasing of the causation standard in Article 2.1 of the Agreement on Safeguards thoroughly masks their intentions.

Professor Lee apparently believes that any shock is an acceptable basis for safeguard measures, as he would deem increased imports to be the "proximate cause" of injury anytime "suppressing imports" would help the domestic industry (which it will, virtually always). He also rejects the limitation in GATT Article XIX that requires the shock in question to be an "unforeseen development". I question whether the drafters of the treaty text had such a broad reading of the text in mind, and whether they intended a causal standard that is so easily satisfied. Indeed, I have considered the interpretation of the causal standard that Professor Lee apparently embraces—what I call the "hypothetical quota approach"—at some length elsewhere in my prior writings, noting its various deficiencies. Among other things, the requirement of "non-attribution" can quickly lead to absurdity as national authorities are asked to distinguish the effects of increased imports from the effects of the causes of increased imports.

But I must confess that I do not know what the proper standard should be, although here and in my other writings I have outlined a number of options and considered their pros and cons. What the system requires is some thoughtful guidance, grounded in sensible policy concerns. That will require either a renegotiation of the Agreement on Safeguards, or a complete change in approach by the Appellate Body. To date, however, the Appellate Body has not even acknowledged the difficulties with the causal standard in the treaty text, and has proceeded as though oblivious to them. Its decisions have thus merely compounded the problem, even to the point of insisting on "non-attribution analysis" that often becomes logically impossible to perform. As I have argued in this reply, Professor Lee's commentary on my earlier article suffers from the same difficulties.

\(^{22}\) In the event of a recession in the importing country, for example, the market share of imports can increase if domestic firms are the marginal suppliers.